L. R. B. & M. JOURNAL

VOLUME 11 NUMBER 4
SEPTEMBER, 1930

Published by
LYBRAND, ROSS BROS. & MONTGOMERY
Accountants and Auditors

L. R. B. & M. JOURNAL

VOLUME ELEVEN SEPTEMBER, 1930 NUMBER FOUR

A Bank's Attitude Toward Inventories

By HOMER N. SWEET

Two questions have been submitted: what the bank's attitude should be with regard to audit of customers' inventories, and what kind of check the bank should advise.

These following recommendations are offered:

First, that the bank should emphasize to its customers that efficient management and accurate inventories are *inter-dependent,* and should encourage customers to authorize audits that shall be thorough and *independent.*

Second, that the bank should endeavor to secure the customer's permission to allow an officer of the bank to have a personal interview with the auditor after each audit, so that the officer may interrogate the auditor on the extent of his verification of inventories and of any other items. Such interviews would assist the bank officers in forming their own judgment of the respective capabilities of auditors and in weighing each audit report or certificate.

In suggesting the above recommendations, certain practical considerations are believed to set the limits of what the bank's policy should be regarding inventories. A brief discussion of the practical considerations in mind may be helpful.

As to the kind of check. If the auditor is to certify the balance sheet without qualification, he should, among other things, verify merchandise inventory sufficiently so that he may be satisfied whether the quantities, the basis of valuation and the computations are substantially accurate and reasonable. The basis of valuation is always an important factor and, therefore, should be thoroughly investigated. Quantities and computations so often are erroneous that those elements also should be carefully verified.

Uncertain elements in the *basis of valuation* are the quality and salability of the merchandise. The auditor must necessarily rely largely upon the concern's officials and employees for correct classification of the different grades and styles of goods on hand and for information and opinion about the probable marketability of the merchandise.

A difficult element of the inventory for the independent auditor to verify is the *quantities.* The extent and method of verification of quantities which the auditor can undertake, within reasonable limits of time and expense, will depend upon the size of the business, the adequacy of the perpetual inventory records, the opportunities for proving quantities by independent checks and the efficiency of the organization having to do with the custody and inventorying of merchandise. The auditor examining the balance sheet of a small, inefficiently organized concern, which has no perpetual inventory records and whose methods of taking inventory are untrustworthy,

may decide that he cannot verify quantities without making a thorough inspection of the goods or attending personally while the inventory is being taken by the concern's employees. On the other hand, the inventory of a very large corporation which is efficiently organized would be accepted ordinarily by the auditor as to quantities without any inspection of the materials, but he would ascertain by investigation of the records whether purchases, production, sales and inventories were co-ordinated, whether the system of stores-keeping was safeguarded, whether stocks were counted regularly through the year as supplies became low, and whether adjustments were currently made to bring the quantities on hand into agreement with the records. Between those two extremes are the majority of concerns whose stocks on hand should be verified as to quantities in varying degrees depending upon the auditor's best judgment of what is the most practicable procedure under the circumstances.

Honest and efficient management within the concern seeking credit are essential prerequisites to accuracy in inventory-taking in the first instance. The effectiveness of audits of inventories is dependent upon the auditor's exercise of good judgment in adapting the scope of his examination to the particular conditions. A vast amount of independent research, which conceivably he might do in testing various opinions concerning the prices and salability of particular articles, he must avoid doing in the interest of economy of time. Time is of the essence in the great majority of audits. The auditor must gauge his work so that his report or certificate will be available within a reasonable time after the statement date.

The foregoing considerations lead to the suggestion that it would be inadvisable for the bank to attempt to advise a kind of check except in general terms as proposed in our first recommendation.

As to the bank's attitude. It is important that the bank should know in each case whether the auditor has verified the inventory to his own satisfaction. A qualification in the certificate or an explanatory note on the face of the balance sheet may signify that the examination of inventories has been restricted. In such cases the credit department of the bank is on notice. The absence of any qualification in the auditor's certificate, or on the face of the balance sheet, should mean that the auditor has satisfactorily verified the inventory, but the bank should understand that the practices of auditing firms will necessarily vary because the verification of inventories is so much a matter of individual judgment. Moreover, some inventories are not susceptible of complete proof. Realizable values of certain goods may be conjectural because of unsettled markets and changes in styles. In order to decide what dependence should be placed on the results of a given audit, bank officers should know the auditor and the condition or restrictions under which he conducted his examination. To this end, bank officers should not only read the auditor's report and certificate carefully, but should also have personal interviews with the auditors.

The Federal Reserve Board published in May, 1929 a pamphlet en-

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Acceptances Under Letters of Credit Against Merchandise Received Under Trust Receipt*

One detail in accounting practice concerning which there seems to be some lack of knowledge, or lack of consideration on the part of accountants, is the treatment of acceptances under letters of credit. In order to avoid misunderstandings it is important that accountants should be thoroughly informed regarding the handling of such transactions.

Ordinarily banks issuing letters of credit either hold documents evidencing possession of the merchandise against which they have accepted drafts, or have delivered the merchandise to the customer on a trust receipt. In either case, the bank holds title to the merchandise, as the trust receipt states that the merchant or manufacturer holds the merchandise at all times in trust for the bank, or if sold, the accounts receivable or proceeds of the sale, as security for the payment of the draft. A bank rarely delivers merchandise under acceptances without securing a trust receipt.

Often it would be difficult to identify or segregate the pledged assets because the merchandise released to the manufacturer on trust receipt may have gone into manufacture and lost its identity before the liability has been discharged. In such cases it is impossible for the accountant to show the specific asset pledged, but it is important to indicate that the bank, theoretically at least, has recourse to the merchandise ahead of any other creditor should the acceptance not be paid. Proper accounting requires that all secured liabilities should be captioned as such.

Acceptances under letters of credit may be described in various ways, but a description which seems to cover this adequately is the following: "Acceptances under letters of credit against merchandise received under trust receipt." This is an exact statement of fact. It is not asserted that the item is collateraled by anything or secured by anything, because neither statement might be correct in the sense that would apply to a regular collateral loan. Everybody, though, who understands the nature of a trust receipt is put on notice that the holder of these acceptances has a lien on certain of the assets which comes ahead of other creditors.

Banks are sometimes blamed for not reporting to the accountant the fact that they hold a lien on the assets covered by acceptances. In some instances the bank may be careless, but at other times the fault lies with the accountant. Frequently the forms used by accountants in confirming liabilities with banks do not call for information covering acceptance credits. Banks have to be careful in reporting dealings with customers and usually feel that they should not volunteer details not called for on the confirmation blank. Accountants should familiarize themselves with the handling of acceptance credits

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* Prepared by the Committee on Cooperation with Public Accountants of the Robert Morris Associates.

A Court Decision on Depreciation

When the excess profits taxes were enacted, and the previously mild federal income tax was increased many fold, many business men for the first time began to take seriously the proposition that depreciation of physical property may occur in spite of adequate current maintenance. The straight line method of computing depreciation allowances was wisely adopted, especially as it had received the hearty approval of the Treasury Department.

One reason, perhaps, why that method, to the general exclusion of others, was so acceptable to the Treasury may well have been its ease of application in a theoretical manner without the necessity for making an actual study of physical facts. An estimate—sometimes a very rough one—having been made of the probable length of life of a certain class of physical property, the rate of depreciation could be applied with ease to the capital expenditures in a given year and continued until the depreciation allowances equalled 100 per cent thereof; then no further depreciation allowances were made regardless of how much longer the machinery continued in service.

Because of insufficient data this method was in many, if not in the majority of cases, the best that could be followed. In a broad way it was equitable and, so far as current depreciation allowances were concerned, taxpayers had little fault to find with it. The Treasury became so enamored, however, of the assumed perfection of the method, that it concluded it should be retroactively applied in computing statutory invested capital. The Treasury refused to recognize, except on the strongest kind of proof, that there might have been indirect provision for depreciation and that, in any event, it was a far fetched proceeding to revamp the plant accounts for a long period of years on a theoretical basis, regardless of what the physical facts might be.

To those who had to meet this procedure of the Treasury, and who saw how some of the staff practically nullified the Commissioner's rulings when he became convinced that theory was running riot to the detriment of reasonable administration, the recent decision of the United States Circuit Court of Appeals for the Seventh Circuit in *Geuder, Paeschke & Frey Company v. Commissioner* was of especial interest. Although bearing directly on the computation of invested capital, which is now to so great extent but a matter of history, it may possibly be an important precedent for application in determining taxable gain or deductible loss on the sale of depreciable property where the Treasury may attempt to compute additional depreciation for past years and thus decrease the "tax basis" of the property in the year of sale.

The *Geuder* case was decided by the Board of Tax Appeals in favor of the Commissioner (11 B.T.A. 1248) but the Circuit Court reversed the Board and held in substance that the Commissioner had erred in reducing invested capital for 1918, 1919 and 1920 on account of alleged inadequate depreciation by applying straight-line rates to buildings, machinery and

equipment, and that the legal presumption of the correctness of the Commissioner's determination had been overcome by the evidence of the corporation's officers that the depreciation shown on the books was adequate. The taxpayer had used varying rates in prior years, in some years charging off no depreciation.

The Court's opinion reads as follows:

Petitioner is a Wisconsin corporation organized in 1882, and since its organization has been engaged in the business of manufacturing tin and japanned sheet metal, galvanized ware, and metal stampings. Its books of accounts showed its invested capital and surplus, a part of which consisted of physical assets of buildings, machinery, tools and dies, factory fixtures and equipment, and automobiles. The company's investment in these assets was shown, and the accounts also showed depreciation reserves and sinking fund accounts representing the amount of accrued depreciation of these assets as determined by the company. In the years prior to 1918 petitioner charged off depreciation on these physical assets at varying rates. This was done for the reason that replacements of machinery parts, prompt and adequate repairs and careful attention in various years arrested the ordinary depreciation, and kept the machinery in proper condition and prolonged its useful life. The cost of such repairs and replacements were not charged to capital investment, but, on the contrary, were charged to operating expense; and at the time petitioner made its return, and subsequently at the hearing, it was absolutely impossible to determine how much petitioner had expended for such repairs and replacements during the previous years of the company's existence.

The record of depreciation sustained on buildings was entered in an account called depreciation account; that of machinery, tools, dies, and other equipment, was entered in the sinking fund account. Mr. Frey, petitioner's secretary and treasurer, who had been connected with the company since 1882, fixed the rates of depreciation for the years 1918 and 1919, and also during the years previous to 1918. He also testified to petitioner's capital accounts for the assets in controversy and the depreciation reserves, and his figures are as follows (see below):

The witness Frey testified that in determining the rates of depreciation he entered sufficient amounts to cover the actual depreciation of the assets, and took into consideration the fact that renewals and replacements were charged as expenses; and that the above column of depreciation reserve reflects the true depreciation of the assets referred to therein. This evidence is also supported by the testimony of Mr. Harmon, auditor of petitioner, who has been associated with the company for over thirty years. It is also supported by the testimony of manager Kempter, who has likewise been associated with the company for thirty years. It is likewise supported in a large measure by witness Roethe, a tax consultant, who made an audit of the books of the company for the period involved, so far as related to a determination of investment and depreciation.

It is uncontradicted that petitioner at all times endeavored to keep its plant and equipment in the best condition possible, and they were in good, efficient operating condition during the taxable years in question. The evidence further shows that there were some years in which no depreciation was taken on

	Capital Account	Depreciation Reserve	Depreciation in Percentage of Asset Account
Buildings	$ 511,148.37	$ 38,249.09	7.5%
Machinery	311,730.32	88,347.01	28.3%
Tools and dies	199,864.77	89,060.83	44.6%
Factory, fixtures and equipment	111,674.47	55,842.46	50.0%
Automobiles	4,784.60	1,342.33	25.9%
Totals	$1,139,202.53	$272,841.72	24.0%

the buildings; however, the only testimony submitted is that the sound depreciated value of these buildings was fully as great as the amount at which they were carried on petitioner's books. Witness Harmon testified positively that he considered the total depreciation on buildings, as shown by petitioner's figures, to be ample.

There was no evidence introduced on behalf of respondent except the Commissioner's computations, but respondent relied entirely on the legal presumption that the Commissioner's determination is *prima facie* correct and will stand unless overcome by competent evidence. In arriving at his figures of depreciation the Commissioner proceeded on the theory that the books and records of petitioner did not provide depreciation in the manner prescribed by the Department, (which, without question, is the best method); therefore it must be presumed that depreciation was not provided for at all. He therefore arbitrarily determined that the invested capital and surplus in the assets referred to were less, by $259,184.25, than the actual capital and surplus as determined by the corporation and as shown on its books of account. He accomplishes this result, in effect, by saying that he allows taxpayer to take depreciation at certain percentages, which he calls permissible rates of depreciation. These percentages of depreciation from 1898 to 1917, inclusive, were applied by Commissioner regardless of petitioner's contention that it had adequately provided for depreciation by renewals and replacements and proper maintenance of its assets, the expense of which was charged to operating expense, thereby reducing its surplus as effectually as a charge to a depreciation reserve would do. The computation began with 1898, because the company's records for earlier years were not available. The Commissioner, for example, applied a straight rate of five per cent. as the rate of depreciation on machinery, on the assumption that machinery would be worn out, exhausted, and useless at the end of twenty years. Theoretically this is quite a safe procedure in the absence of better evidence; but in this particular case there were machines that had been in use as long as forty-five years and were still rendering proper service, due to keeping them in good repair and promptly replacing all broken parts, and making such renewals as were necessary. This fact proves conclusively that no rule or rate can in all instances accurately measure depreciation. While it may form a safe basis for a *prima facie* case, it must give way to the facts in each particular case if those facts are presented and are inconsistent with the rate.

Previous to the enactment providing for income tax the necessity for detailed records of depreciation was not so apparent as now, and they were not kept in such manner as to be fully informative. Since the enactment many taxpayers have learned this, and have been greatly benefited thereby, so far as the future is concerned. We think this fact merits consideration, and it has generously received consideration at the hands of the United States Board of Tax Appeals.

In the case of *Appeal of Cleveland Home Brewing Co.*, 1 B. T. A. 87, the Board used the following language:

> "Depreciation * * * is a question of fact. Congress has allowed taxpayers a 'reasonable allowance for * * * wear and tear of property used in the trade or business' as a deduction from income, to make whole their capital investments before levying a tax upon that income. The Commissioner in this case asks us to accept a readjustment of taxpayer's invested capital upon a mere assumption that the property of *this taxpayer* was reasonably depreciable at certain arbitrary rates and in equal annual amounts over a period of 11 *completed* years. No evidence is offered that the alleged depreciation has actually occurred. None is even offered that property of the kind here in question usually deteriorates at approximately the rates used in the computations of the examining agent. Upon the record so made, we must sustain the position of the taxpayer."

At this point the Court quoted at some length from the Board's opinion in *Appeal of Kansas Milling Co.*, 3 B. T. A. 709, and *Marigold Garden Company and Randolph Hotel v. Commissioner*, 6 B. T. A. 368, the purport of which was similar to the above

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The L. R. B. & M. Journal

Published by Lybrand, Ross Bros. and Montgomery, for free distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvements; to encourage and maintain a proper spirit of cooperation and interest and to help in the solution of common problems.

Offices in the South

Ever since the founding of our firm we have had engagements for clients who were located in the South or who had interests there. These engagements have for the most part been handled from our Northern offices, or in the case of Texas by Messrs. Peter & Moss of Dallas, with whom we have had reciprocal relations for many years.

The industrial growth of the South, which during recent years has been hardly short of phenomenal, is a development which has brought with it an increasing call upon public accountants. In order to render the most effective service to our clients, it has seemed desirable that we have several offices in the South, thus rounding out the geographical scope of our organization.

An office has therefore been opened in Atlanta, Georgia, which is the

natural business center of the Southern states east of the Mississippi. The Atlanta office is in charge of Mr. Stephen B. Ives, who is an alumnus of Harvard University and who received his accountancy training in our New York office. His experience has been such as to equip him to make the Atlanta office a helpful one to those of our clients who have occasion to utilize its services.

An office has been established also in Dallas, Texas, by the merger of the practice of Messrs. Peter & Moss with that of our firm. We welcome warmly to our L. R. B. & M. organization these old friends. The members of the former firm of Messrs. Peter & Moss will continue their association with us as partners at the Dallas office. The enlarged facilities will permit of still more effective service to their clients and ours in the Southwest, especially to those who have business or financial relations with New York and other sections of the country.

Serving Our Profession

Theodore Roosevelt is quoted as having said on one occasion that every man owes his profession a part of his time in unselfish service. Opportunities for doing so present themselves ever and anon.

At the annual convention of the National Association of Cost Accountants held in Syracuse in June last, Mr. Gee was elected president. This is a gratifying recognition of the service he has been rendering the Association in one way and another ever since its organization. This is the second time a member of our firm has been chosen to lead the Association, Mr. Lybrand having been its second president.

Mr. Marsh has but recently completed his term of office as president of the Pittsburgh Chapter of the Association. He is also serving on a committee which is studying the accountancy course of the University of Pittsburgh for the purpose of submitting a report on the content and presentation of the course. Mr. L. F. Blake, of our Boston office, has recently been elected treasurer of the Chapter in that city.

At the annual meeting of the New York State Society of Certified Public Accountants in May last, Mr. Staub and Mr. Sinclair were elected first vice-president and treasurer, respectively, of the Society.

Another International Congress Echo

Not long ago there came into the writer's hands a copy of the Current Economics publication which is issued periodically by the Osaka University of Commerce in Japan. A large part of this issue was devoted to an article on "The Third International Congress on Accounting" by Professor S. Suyama, one of the Japanese delegates to the Congress in September of last year.

The publication was entirely in Japanese, excepting for the titles of papers and the names of participants in the program. Hence, the writer had to forego the pleasure of reading Professor Suyama's comments on the Congress, and had to content himself with seeing Colonel Montgomery's name given as President of the Congress and noting among the schedule of papers presented that of Mr. Gee on "Accounting for Burden" and that of Mr. Staub on "Consolidated Financial Statements."

The Financial Statement Interpreted for the Public*

Henry C. Hawes
(*Chicago Office*)

Since the investment bankers and brokers are quite familiar with the language employed by the accountant the matter of interpretation resolves itself into an explanation of principles underlying financial statements and a pointing out of the need for reading carefully.

Any public statement of condition must be quite abbreviated because of the limitations of space and because experience has taught that it is usually not expedient to disclose detailed information to competitors and others. The accountant's comments, which usually accompany the balance sheet, do not find their way into the hands of the public and oftentimes neither the operating statement nor surplus account are disclosed, although they are essential to a proper understanding of the financial position.

At the present time most corporations that borrow money have audits, as do those where the capital stock is not closely held. If a corporation's annual report or other submitted statements are not accompanied by an auditor's certificate, the reader is warned by its absence to beware. There have been cases where the auditor's certificate has been rendered but, for reasons best known to themselves, the company's officers have made public a statement prepared internally, without reference to the audit report. In other cases statements have been made public with the reference that annual audits are made by a designated firm of public accountants. Such reference is not sufficient, as there is no assurance that the auditor's findings agree with the published statements.

In case statements are submitted with an auditor's certificate, both statement and certificate should be carefully read. Certificates are of two kinds: those which are qualified and those which are unqualified, and the public should be alert to the import of any and all qualifications, designated by footnotes or otherwise shown, on the face of statements.

While the accountant is reluctant to issue a qualified certificate, it is sometimes necessary to do so, occasionally in cases where the true facts cannot be determined, or, more generally, in cases where the client restricts the scope of the examination or refuses to accept changes necessary to permit certification without qualification.

Accountancy is not an exact science and financial statements represent the conclusions of those who prepare them. The conclusions, of course, are made from the information obtained and vary with the experience and ability of the individual or group that assumes the responsibility for the statements. Such statements, therefore, are not infallible although when prepared by qualified persons and submitted without reservation they may be accepted with confidence.

It is, therefore, important that the public know whether or not a given statement was prepared as the result of an independent examination by an experienced accountant of good char-

* A paper presented at the Convention of Associated Stock Exchanges in Minneapolis on May 20, 1930.

acter who has ability and good business judgment.

The balance sheet has been defined as "a condensed statement of the assets, liabilities and net worth or deficiency of an individual organization, or any financial entity, at a given date."

It is in reality an instantaneous picture of the financial position and is necessarily of a historical nature since the financial position may and often does change quite rapidly.

Balance sheets are usually based upon the theory of going concern value, that is the value in use to a continuing company. Creditors should not accept the stated value of assets as a guide to their forced market or liquidating value.

In this connection the following quotation from an article appearing in a recent issue of a widely read financial magazine is of interest:

> "The book value calculated from a corporation balance sheet is a purely theoretical figure. In theory, it is the net worth of the common stock if the business were suddenly shut up, all assets realized upon, all prior claims paid off and the entire business liquidated."

The above shows that even the author of the article, a financial writer, does not properly interpret a balance sheet. As previously stated the balance sheet of a going concern is not and never was intended to reflect realizable values throughout.

One must understand the theory underlying the valuation of each balance sheet item in order to interpret the balance sheet. Accounting practice may at some remote date change to a basis of valuation at realizable market value or present day value. At present the general theory of valuation is historical cost, adjusted in certain cases where it is expected that actual losses will be realized in the near future. Profits are not taken until they are realized.

The balance sheet as now constituted is important primarily in the determination of earnings. The items which are not income of a current period are applied to reduce assets or are carried as liabilities. Transactions which are not expenses of the period either serve to reduce the liabilities or are carried as assets on the balance sheet. Earnings consist of realized and accrued income less expenses, including estimated near term losses unrealized at the balance sheet date and allowances for replacement of wasting assets.

In interpreting a financial statement consideration should be given to the size and type of the business unit. No one should attempt to draw comparisons between the statements of industrial organizations and those of public utility companies, and in many instances, it would be useless to compare either the financial status or operating statistics of one type of industrial with one of a different type.

Ratios of current assets to current liabilities, and of individual items within those groups to the total of the groups, will naturally vary with the type of business. Also the ratio of plant investment and of other assets to total assets or to capital will fluctuate between industries. It is, therefore, necessary in interpreting a given financial statement to make comparisons with other business units of similar type, size and condition.

Comparisons should also be made, if possible, of the current balance sheet with the one of a year previous if any conclusions are to be drawn as to progress and financial policies.

Regardless of the type of company whose balance sheet is under consideration there are certain points common to all which call for interpretation.

In view of the wide varieties in state corporation laws, it is advisable to know in what state a company is incorporated. This information might be set forth opposite the company's name or as a memorandum under the caption "Capital."

Items of different character should not be grouped under a compound caption and, in cases where general descriptions are used, the reader should examine carefully and perhaps secure the amounts of each item included in the general caption.

It should be determined whether or not the accounts receivable or investments include interests in subsidiary companies. In the event that the investments represent more than a fifty per cent interest in a subsidiary, a consolidated balance sheet of the parent and subsidiary, or a separate statement of the subsidiary, may be required for a proper understanding of the situation. Oftentimes the picture is entirely changed when this information is obtained. There is not sufficient time to discuss the questions as to when a consolidated statement should be made, as to what values should be placed upon the assets consolidated, and as to the treatment which should be accorded the various surplus accounts, or any other of the important features which must be given consideration when a consolidation is made. Much has been written on these points and the matters should be given careful study by the recipient of a balance sheet of a company having subsidiary interests.

As an illustration of the need for consolidated statements reference is made to the case of a well known manufacturer who issued a balance sheet with the object of reassuring the public as to his financial strength. The product of the company was being distributed largely through subsidiary corporations. The published statement made only slight reference to the subsidiary companies under the caption of investments, which really represented the aggregate of the capital stocks of the subsidiary companies at par value. The public did not realize that the item of receivables included large amounts due by the subsidiary companies for finished product in their warehouses. The corporation drifted into financial difficulties and those who placed reliance on the statement and invested on its good showing incurred heavy losses. A consolidated statement should have been submitted with warehouse items taken up as inventory, valued at factory cost plus freight, and not shown as receivables including unrealized profits.

In the case of industrial or commercial enterprises, the balance sheet is usually arranged with the assets stated in the order in which it is anticipated they will be converted into cash. Likewise the liabilities are shown in the general order in which they will be paid or in the order of their preference under the law. Although there is no fixed rule in regard to what constitutes current assets, it may be said in general that all items are excluded therefrom which will not be converted into cash within one year. Also, advances to officers and employees are usually excluded to avoid abuses which might follow the practice of treating such items as current assets. Marketable securities although readily realizable are usually not included with current

assets if it is the intention to hold them for investment over a longer period than one year.

All liabilities which mature beyond one year from date of the balance sheet and others of a contingent nature, which have been reserved for, are ordinarily excluded from the current obligations.

Although a detailed discussion of balance sheets cannot be made I have selected certain of the more important items for consideration.

Inventories

In the case of manufacturers and merchants the inventory is usually the largest single item of importance on the balance sheet from the standpoints of value and of effect upon future profits. The various bases of inventory valuation are (1) cost, (2) market value, (3) cost or market value, whichever is lower, (4) modifications of the above. Conservative practice accounts for the use in most cases of the lower of cost or market value. The use of market values for by-products of flour milling, meat packing and certain other businesses is considered sound practice, as the cost of the main products is dependent upon the realizable value of the by-products.

The basis of inventory valuation should be revealed to the public; the failure to do so may raise question. In case the stated basis of valuation is cost, the interpreter should seek to determine whether the actual value is less than cost because of market declines, unbalanced quantities, obsolescence, physical condition, etc. In case market values are used the reader is on notice that unrealized profit is probably included. The use of the words "estimated cost" indicates that actual cost data were not available and while the total value may be substantially correct it should not be accepted with finality.

Since inventories may be readily overvalued through the inflation of quantities the public should insist on knowing what steps were taken, if any, to verify the quantities. Too much stress cannot be laid on the importance of this point. Where an unqualified certificate is given it may be assumed that the accountants have satisfied themselves as to total inventory values. In cases where any qualification of inventories is made the public should realize that possibility of overstatement exists.

Marketable Securities

If marketable securities are valued at cost, as is usually the case except with security dealers, the market value at date of the balance sheet should also be shown as an explanation. The question as to whether the so-called investment trust type of company may value security holdings, rights, and stock dividends at market values is a debatable one which is receiving great attention at the present time. During September, 1929, the president of the New York Stock Exchange announced:

> At the present time it appears that the Exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus account by paying companies.

While market value was urged as a proper basis for stock dividend valuation before the recent deflation in the security markets, sentiment now seems to be changing to the more conservative basis of placing no value on such dividends until realized through sale.

The determination of the amount of realized profit in case of sale of dividend stock is also a controversial subject at present. Needless to say the statements of investment trusts require careful interpretation.

Deferred Charges

There should be included in deferred charges only items expended which will have a definite value to future operations. The items often included with deferred charges are bond discount, prepaid interest, unexpired insurance premiums, supplies, prepaid rent, taxes, advertising, organization expense, developmental costs, etc. Since it is difficult in the case of certain items to determine with accuracy the amount of future benefit to be derived therefrom, the net worth is sometimes overstated by considerable amounts due to assuming too liberal an attitude toward such items. A conservative management usually charges off organization and development expenses immediately or over a short period and when large amounts appear therefor on a balance sheet question should be raised.

Fixed Assets

The basis for valuing fixed assets should be disclosed, as it may be either historical cost, cost in common stock or cash at date of a consolidation, or appraised value. With the exception of land, fixed assets are not stated at market value, as such value is difficult to determine and ordinarily it would be quite low. The true value of any plant is its going concern value, that is, its value to the particular company for a given use. The ultimate security to mortgage holders is the earning power of the properties or, in extreme cases, the salvage value in case of a sale. A plant may be suited only for a particular use at a given point, or it may be inefficient and partially obsolete, so that its ready market value in either case would be low in relation to cost or appraised value.

Appraisal values are of interest as they indicate what it would cost at a given date to reproduce the identical properties in their present condition. Appraised net sound values are not intended to reflect market values and they ordinarily do not give effect to extraordinary obsolescence.

The important phase of fixed asset valuations is their effect upon the determination of earnings. A fundamental of corporate trusteeship is that paid-in capital be segregated and preserved for the owners. If fixed assets are carried at cost and ample provision is made for preserving the original investment in such assets, the interests of the owners and creditors have been served. The preservation of the original investment is accomplished through a charge to operations for depreciation and obsolescence, which is recovered in the sales price of the product or merchandise handled. It is being contended by some that, in case appraised values are shown on a financial statement, the operations should be charged with depreciation on such values rather than on cost. This is recommended in order to protect security holders or creditors who have

advanced money on the strength of appraised values which in most cases are in excess of the cost basis.

It is evident that the public should know the basis for depreciation and the annual rates applied to each class of property. While it is true that depreciation is only an approximation and that theories of depreciation are complicated, experience has taught certain general rules which can be used to test the reasonableness of the annual allowance for wear and obsolescence.

Liabilities

Little need be said in regard to the liability section of the balance sheet. Known liabilities which are definitely determinable are usually clearly set forth on the financial statement. However, attention should be drawn to liabilities of a contingent nature which are the "effect of acts or conditions prior to the date of the balance sheet which may become actual liabilities after that date." Included in this category are such things as litigation in connection with infringements of patents, breach of contract, income taxes, and contractual claims of various kinds. There are also included in this classification any contingencies which may result in loss or may affect the ratio of current assets to current liabilities, such as discount of negotiable paper, indorsements and guarantees, pledge or assignment of assets, outstanding letters of credit, purchase commitments, etc. It is customary to mention all such items as a note on the balance sheet with amounts shown to indicate the maximum liability. The interpretation of all such comments should be done with care, since extremely important contingencies may appear quite innocuous as they are described on the statement.

The use of reserves on the liability side of the balance sheet beneath the current liabilities may lead to confusion on the part of the public. Where reserves are carried for the valuation of assets they should be deducted directly from the assets. Other reserves which often do not represent actual liabilities merely reflect conservative policies of the management. Such reserves are really appropriated surplus and should be considered a part of the net worth. In any given instance it may be difficult to interpret the true meaning of these reserves but sufficient information should be secured to enable the reader to judge them correctly.

Capital Stock

Securities, like ladies' wearing apparel, are a matter of fashion. During a recent discussion between a banker and a radio manufacturer the latter stated that obsolescence was a great factor in the radio industry, anything over two years old being antique. The banker then remarked "and so it is with types of investment securities".

The capital stock section of the balance sheet cannot be interpreted at present without careful study of each classification as to preference, dividends, conversion privileges, options, warrants, rights, call price, voting privileges, etc. In some cases the capital stock covenants are so voluminous and so involved that they cannot be adequately disclosed on the face of a balance sheet. This is especially true of many of the issues floated during the past two years. Even the well known Philadelphia lawyer must have difficulty in understanding their unique terms in some cases.

Ordinarily, the stock issues are listed on the balance sheet in the order of their preference as to assets. The information shown usually includes number of shares authorized and issued, value per share in case of par value stock, and dividend provisions in case of preferred stock.

The balance sheet interpreter in analyzing the capital structure should know how much was issued for cash, for other tangible assets, goodwill, appreciation of fixed assets in a reorganization, and stock dividends. This is particularly advisable in the case of no par stock issues. In recent times it has become possible for a corporation by directors' action to place almost any value on assets received in exchange for no par common stock with a corresponding value ascribed to the stock itself. The basis and circumstances under which the assets were valued should be revealed, particularly in cases of reorganization where actual ownership does not change. The public also should know whether the stock was issued during a period of security inflation or depression.

When the market value of the stock at date of issuance in an inflated market is placed on the assets acquired, caution should be exercised in considering the asset values thus determined.

Let us assume that at date of incorporation the market value of a company's stock was $60 per share and that the present deflated value is $30 per share. This present price indicates that the fixed and intangible assets are now appraised by the public at much less than the values at which they are carried in the balance sheet.

A buyer of common stocks should pay particular attention to bond and preferred stock conversion privileges and their possible effect when consummated. Options given to buy additional common stock at a stipulated price less than the book or market value may serve to dilute the stock in hands of present holders.

The subject of the value of dividends paid in no par common stock and transferred to capital stock is one of considerable controversy. It is argued by some that since no assets have been distributed to stockholders there should be no value transferred from surplus to capital stock but only the additional shares outstanding should be indicated. Since the purpose of quarterly stock dividends is to withhold earnings from distribution in cash, the end is defeated unless some transfer is made in connection with such dividend payments. The question then arises as to the amount to be transferred, whether it shall be the statutory or declared value per share, the value per share carried on the books, or market value at date of distribution. The latter method had many advocates among investment trusts and other dividend recipients during 1929, while at the present time a more conservative viewpoint is being taken. In any case the effect upon capital stock and surplus is such that the balance sheet interpreter should learn the facts.

Surplus

Surplus at first thought may be considered as being undistributed earnings. In addition to such earned surplus, however, one may find paid-in surplus, donated surplus, appraisal surplus, appropriated surplus and mixtures thereof.

The various surplus classifications should be segregated on the balance

sheet to disclose how the items arose. While earned surplus from an economic standpoint is the only amount available for true dividends, certain state laws permit the payment of dividends out of other forms of surplus without disclosure of the source of the distribution. When dividends are paid from other than earned surplus they constitute, in fact, a return of capital or of an unrealized book gain. An example of the latter would be a payment on the basis of appreciation of fixed assets.

A practice occasionally found is that of charging paid-in surplus with organization expenses, unamortized discount on bonds, commissions and discounts on sale of capital stock, and premiums paid in the purchase of par value capital stock. Also there have been instances where goodwill and fixed assets have been written down through a charge to surplus on the grounds of conservatism. The principal danger in some cases of such procedure is that the ensuing earnings may be distorted thereby.

Where the general term "Surplus" is found on a balance sheet without explanation the interpretation should be that there may be included any one or all of the classifications and adjustments outlined herein.

As an ideal it may be suggested that each and every balance sheet be accompanied by an analysis of capital stock and surplus accounts.

The subject of sinking funds, which are in reality appropriated surplus temporarily withheld from distribution, deserves mention. Such funds are created for the retirement of debenture and mortgage bonds and preferred stocks. It is the intention of most sinking fund agreements that earnings be retained in the business in sufficient amounts to replace the loan or capital by the time it is fully retired. The business is assumed to need the funds, secured from the public, permanently and since the bonds or stocks are being retired an equivalent amount must be added out of earnings, a substitution of funds thereby taking place. The sinking fund protects the interest of security holders and after the securities are all retired the sinking fund may be transferred to earned surplus and become available for distribution if deemed advisable by the directors. An understanding of these principles is necessary in order to interpret properly the meaning of sinking funds.

If time permitted it would be helpful to select a few typical financial statements and attempt to interpret them for you but that must now be left for you to do.

INVENTORY TURNOVER

MANUFACTURING INDUSTRIES—COMPILED FROM STATISTICS OF INCOME PUBLISHED BY UNITED STATES TREASURY

	Gross Sales or Operating Revenue 1927	Inventories 1927	Sales Divided by Ending Inventories 1927	1926	1925
Food products	$13,612,366,140	$ 1,823,919,385	7.5	7.7	8.4
Textile products	7,642,397,127	1,859,359,759	4.1	4.3	4.1
Leather products	1,692,878,149	421,561,865	4.0	4.1	3.4
Rubber products	1,413,986,026	331,008,530	4.3	4.5	5.9
Lumber products	2,694,795,244	740,276,263	3.6	3.8	3.9
Paper products	1,596,282,059	298,315,896	5.4	5.4	5.2
Printing	2,143,229,019	218,964,531	9.8	9.9	9.5
Chemicals	8,036,189,168	1,464,605,333	5.5	4.0	4.6
Stone, clay and glass	1,558,058,089	319,982,765	4.9	5.2	6.6
Metal manufacture	18,411,159,316	3,900,632,525	4.7	4.4	4.6
All other manufacturing	2,130,542,383	505,267,066	4.2	4.1	4.4
Total	$60,931,882,720	$11,883,893,918	5.1	4.9	5.1

DEPARTMENT STORES—FROM BULLETIN NO. 78, MAY, 1929 OF BUREAU OF BUSINESS RESEARCH, HARVARD UNIVERSITY

	Rate of Stock-turn—Year 1928 Less than 3 times	3-3.9 times	4 times and over
Typical Net Sales	$2,400,000	$2,500,000	$5,500,000
Sales per Employee	6,500	7,500	8,000
Sales per Square Foot Selling Space	24.00	34.00	45.00
Sales per Square Foot Total Space	19.25	23.50	27.00
Rent per Square Foot Selling Space	.90	1.00	1.50
Rent per Square Foot Total Space	.70	.70	.95
Proportion of Selling Space to Total Space	79%	66%	63%

The typical rate of stock-turn in department stores in 1928 was 3.9 times based on beginning and ending inventories, and 3.5 times based on monthly inventories, in each case where cost of sales is the other factor.

PERCENTAGES OF INVENTORIES TO OTHER ASSETS

FROM CORPORATION PROFITS BY LAURENCE H. SLOAN
PUBLISHED BY HARPER & BROTHERS

No. of Cos.	GROUP	Percentage of Current Assets in Inventories 1926	Inventories 1927	Accts. Recble. 1927	Cash 1927
16	Tobacco Products	70.8%	72.6%	12.6%	14.8%
3	Leather	70.2	67.4	27.0	5.6
4	Woolen Goods	63.5	66.1	*29.1	*11.4
4	Silk Goods	61.9	63.8	25.6	10.6
13	Theaters, Moving Pictures, and Amusements	60.3	62.9	18.7	18.4
7	Paper	55.9	59.5	19.6	20.9
6	Cotton Goods	53.3	59.0	26.6	14.4
47	Oil	55.9	57.6	20.7	*23.0
17	Copper	55.2	57.4	13.0	21.6
3	Meat Packing	52.9	55.7	33.0	11.3
13	Sugar	51.4	55.6	26.1	18.3
9	Automobile Tires	58.4	55.0	31.1	13.9
50	Retail Trade	52.6	52.9	17.9	29.4
13	Apparel	51.0	52.4	34.6	13.1
21	Steel	48.6	50.8	18.2	31.0
4	Shoes	47.1	47.5	34.8	17.7
10	Coal	32.2	47.4	*32.7	*24.5
22	Machinery and Machine Equipment	45.3	44.9	35.2	19.9
14	Miscellaneous Mining and Smelting	45.8	44.6	14.3	41.1
3	Fertilizers	36.4	42.9	35.3	21.8
14	Household Equipment and Supplies	50.1	42.8	35.5	21.8
29	Building Equipment and Supplies	42.0	42.2	29.1	*28.9
23	Automobiles	45.1	41.2	13.7	45.1
33	Miscellaneous Manufacturing	40.8	41.1	27.2	31.7
22	Automobile Parts and Accessories	40.9	39.5	18.5	42.0
36	Food Products	35.4	37.0	17.5	45.5
7	Agricultural Implements	43.3	36.4	46.4	17.2
6	Electrical Equipment	34.8	33.5	20.3	46.2
14	Chemicals (Industrial)	34.2	32.1	18.8	49.1
9	Drugs, Medicines, Cosmetics, etc.	31.8	31.9	24.1	44.0
8	Radio and Musical Instruments	42.1	30.5	36.0	33.5
7	Office and Business Equipment and Supplies	32.5	28.8	*39.1	*32.2
7	Lead and Zinc	26.2	26.5	10.1	63.4
13	Railroad Equipment	22.0	20.9	24.0	55.1
5	Shipping and Shipbuilding	13.1	10.4	*33.6	*58.7
	Average, 513 Companies	49.0%	48.5%		

* Approximate.

FROM BULLETIN NO. 29, JANUARY 7, 1930

PUBLISHED BY UNIVERSITY OF ILLINOIS

Ratio	Automobile 1920	Automobile 1926	Parts and Accessory 1920	Parts and Accessory 1926
Inventory to Total Assets	.442	.284	.346	.193
Current Assets to Total Assets	.695	.560	.503	.448

Notes

A recent issue of the *Betriebswirtschaftliche Rundschau und Archiv fuer Revisions und Treuhandwesen,* a scientific management magazine published by an organization of accountants in Germany, contained as its leading article one by Mr. Sweet of our firm entitled "Kritische Bemerkungen ueber die Buchungsmethoden gemeinnutziger Koerperschaften in den Vereinigten Staaten von Nordamerika." The title of the article in the original English was "Significant Accounting Policies of Public Utility Corporations in the United States." The translation into German was exceptionally well done.

A Bank's Attitude Toward Inventories

(*Continued from page* 2)

titled "Verification of Financial Statements," submitted, as the title page shows, for the consideration of bankers, merchants, manufacturers, auditors and accountants. This pamphlet contains detailed, technical procedure for audit of inventories and the other accounts, all subject to the reservation that the extent of the verification is to be determined by the auditor in each case on his responsibility with regard for the conditions in the particular concern. It is not believed advisable for the bank to distribute copies of this pamphlet indiscriminately to every customer, but giving the pamphlet to a customer disinclined to authorize a thorough audit might be persuasive.

A Court Decision on Depreciation

(*Continued from page* 6)

quoted opinion of the Board in *Appeal of Cleveland Home Brewing Co.* The court then goes on to say:

The Commissioner calls our attention to the decisions of the Board in *Appeal of City National Bank,* 2 B. T. A. 623, and *Appeal of Union Terminal Cold Storage Co.,* 4 B. T. A. 264, and contends that these cases subsequently considered and distinguished the appeals of *Cleveland Home Brewing Co., Russell Milling Co.,* and *Rub-No-More Co., supra.* These cases merely distinguish the facts from those in the older cases, and a reading of these two later cases cited by the Commissioner shows that the facts are quite dissimilar; in fact, in the *Appeal of Union Terminal Cold Storage Co.* there was no evidence whatever introduced to show that taxpayer had ever charged off any depreciation. In the instant case the officers of taxpayer, who have been closely and continuously associated with it for thirty years or more, are positive in their testimony that the amount of depreciation sustained during the preceding years is identical with the amount charged off by taxpayer. This we regard sufficient, under the decisions of the Board from which we have quoted, to overcome the *prima facie* case made by the Commissioner's finding. This position is fully supported by *Haugh & Keenan Storage & Transfer Co. v. Heiner,* 20 F. (2d) 921. For this reason it is not necessary to discuss other assignments of error.

The order is reversed.

It may be stated in conclusion that, after all, depreciation, or the determination of proper allowance therefor, depends on the circumstances of each case. Theoretical rules cannot be blindly applied but an effort must be made to ascertain and apply all the facts which have a bearing on the case.

Acceptances Under Letters of Credit Against Merchandise Received Under Trust Receipt

(*Continued from page* 3)

and should frame their questions to the banks with sufficient completeness to cover all important phases of these transactions. If acceptances are known to exist, the accountant should satisfy himself that he has all the facts and should present them properly.

Reproduction of first page of the report on the Third International Congress in Accounting which appeared in the current economics publication of Osaka University of Commerce.

更に物價の下落を

河田嗣郎

一　解禁の條件にして結果たる物價下落

金解禁の條件でもあり又その結果でもあらねばならぬ所のものは、物價の引下げといふことである。世界大戰期以來我が國の物價が暴騰して、指數の比較上から見て其の騰貴率は遙かに英米のそれを凌駕する有樣だつたことは、我が國の經濟實力の上からいふも、世界的物價標準の上からいふも、確かに調子外れの有樣であつて、その影響は國民經濟內部に於ても又對外關係に於ても實に著しいものがあつた。卽ちこれがために國民所得の分配が紊亂し、國民中の多數者特に勤勞階級の生活を苦難ならしむると同時に、對外貿易上に於ては甚しく輸出を困難ならしめ輸入を促進せしめて、常に國際貸借上のバランスを逆調ならしめ爲替相場の下落の勢を固定せしめたことは、周知の事實である。この憂ふべき狀勢を轉換して我が經濟界一般に渉つて順調な狀態を造り出すことの必要は、終に多くの困難と少からざる犧牲とを忍んで金解禁を斷行するの止むべからざるに至らしめた。

然かもその金解禁を斷行するに就いては、國際貸借上のバランスを相當の程度まで順調に引戾すことが條件的